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***Statement of Micah S. Green
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***Testimony before
U.S. House of Representatives
Subcommittee on Financial Institutions and Consumer Credit
Subcommittee on Housing and Community Opportunity***

***Hearing on Promoting Homeownership by Ensuring Liquidity in the
Subprime Mortgage Market
June 23, 2004***

Thank you Chairmen Bachus and Ney along with Ranking Members Sanders and Waters for holding this important hearing on the need for liquidity in the market for subprime mortgage loans. We also thank other members of the full Committee who have been helpful in advancing the discussion of the policy challenges facing subprime lending.

Home mortgage credit for subprime borrowers—the segment of mortgage customers with less-than-perfect credit—is more widely available at a lower cost today than ever before, in part because securitization provides a more liquid market for these loans. Securitization and the secondary market efficiently link the mortgage and capital markets, providing more credit at a lower price than would otherwise be available. As a result, more subprime borrowers are able to obtain mortgage financing and purchase homes than would otherwise be the case.

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Unfortunately, the subprime sector of the consumer credit market is also the most likely to attract predatory lenders. With the Homeownership and Equity Protection Act (HOEPA) in 1994, Congress restricted certain lending practices for high-cost loans in an effort to protect the most vulnerable subprime borrowers. The law built on the legal notion of “assignee liability” or the potential that liability for lending violations could be assigned to a loan purchaser. In their own efforts to combat predatory lending, state and local governments have passed new laws that move beyond HOEPA’s assignee liability provision. The result is a patchwork of laws in a cross-section of jurisdictions that sometimes use vague and conflicting standards to make secondary market participants liable for lending violations. When applied this

way, assignee liability provisions have caused some loan purchasers to curtail and—in some instances—stop securitizing loans made in certain jurisdictions. The situation threatens to drive up the cost and limit the availability of credit for subprime borrowers.

Securitization and the Secondary Market for Mortgage Loans

Mortgage securitization involves the transformation of mortgage loans into mortgage-backed securities (MBS) that are issued and traded in the capital markets. The principal and interest payments on mortgages are pooled and passed through as payments to bondholders. The financial institution that originated the loan can put its proceeds from selling the loan back to work in the form of a new mortgage. This process accelerates the flow of mortgage funding and results in lower cost and more widely available credit for borrowers.

Loan purchasers must take steps to understand the quality of the pools of loans acquired to issue MBS. MBS issuers need to assure investors the loans in a pool will perform—or that borrowers will make timely mortgage payments—in order to achieve the best pricing in the capital markets. Loans made under predatory terms are often more likely to default than other loans which is further motivation for loan purchasers to eliminate bad loans from the pools they acquire.

The review of loan pools, which is also called due diligence, actually occurs at two levels—the loan supplier and with the loan itself. With the loan supplier, among the issues considered are any lending abuse-related litigation and the supplier's lending record. Loan purchasers are careful to establish they are doing business with a reputable supplier. Screening individual loans involves a review of the documentation of the mortgages for indications the loan was extended under prohibited terms. Loan purchasers also look for conformity with underwriting guidelines and the integrity of the loan data.

Typically, loan purchasers will review a sample of the mortgages for compliance with applicable laws. The entire review process relies on representations and warranties the loan originator makes regarding the accuracy of loan pool documentation. Not having taken part in the lending process, the loan purchaser cannot know if a high-cost loan originator acted in a way that violates an anti-predatory lending law unless the results of that action can be objectively recorded in the loan file. The interest rate a loan carries, for example, is easy to detect from the loan file. Whether or not the lender misrepresented an important loan term, on the other hand, will not be reflected in the loan documentation.

Regulatory Approaches to Curbing Predatory Lending

HOEPA has been the primary regulatory weapon against predatory lending since its enactment in 1994. The law created the concept of a “high-cost” loan as one with an annual percentage rate or fees that exceed a threshold. The Federal Reserve Board has the authority to adjust the threshold which is presently set at 8 percentage points over the yield on a Treasury security of comparable maturity. Alternatively, loans

that carry points or fees the greater of \$499 or 8 percent of the loan amount qualify as high-cost under HOEPA. The Fed also writes the regulation guiding the law's implementation.

In recent years, several states and localities have built on HOEPA's fundamental approach with new anti-predatory lending laws to the point that up to 70 percent of the subprime market could now be affected. Of the more than 40 varying state and local anti-predatory lending laws, many employ a lower threshold than HOEPA. Loans that fall into the high-cost category are subject to certain restrictions. Terms deemed to have the potential to be predatory are prohibited.

Many of the laws use subjective triggers to assign liability to the loan purchasers. In some cases, this subjectivity creates legal circumstances inconsistent with the notion of fundamental fairness. A loan purchaser should not face liability for lender actions it did not observe and that cannot be detected in the loan file.

Using anything but a single set of objective and readily detectable standards to determine whether an assignee has liability is a regulatory approach that threatens to undermine many of the benefits of the secondary market. Faced with this type of environment, secondary market participants may find it less attractive to purchase and repack subprime loans.

The Association believes the current regulatory environment negates many of the efficiencies securitization and the secondary market bring to the subprime mortgage market. Anti-predatory lending laws that assign liability to the secondary market for lending violations that cannot be detected in a review of the loan documents will ultimately limit subprime borrowers' access to credit.

The Association supports a single federal standard and is ready to work with Congress in crafting a federal anti-predatory lending law that uses clear and objective standards to address the harmful lending abuses that occur in the subprime mortgage market. The new law should assign liability to the secondary market only for those lending violations that can be detected in a review of regular loan documentation.

The Need for Clarity and Objectivity

Association members believe Congress should draft legislation that would not violate the fundamental notion of fairness with respect to the secondary market by assigning liability to loan purchasers for lender behavior that was not witnessed and cannot be detected in the loan file. There are many current examples of state and local anti-predatory lending laws that contain ambiguous definitions of lending violations for which a loan purchaser could be liable. It is the Association's view that some of these provisions can be successfully clarified. Some jurisdictions, however, have enacted laws containing requirements that cannot be met under any circumstances.

Set out below are examples—taken from existing state and local laws—of provisions that fall into three categories: “clear and objective”, “objective but not clear” and “not objective.”

1. Clear and Objective

- Negative Amortization

“No high-cost home loan may contain a payment schedule with regular periodic payments that cause the principal balance to increase.” (North Carolina, New York State)

2. Objective, but not Clear

- Repayment Ability

A borrower’s ability to repay a loan is a key element of the underwriting decision. A lack of documentation of repayment ability could indicate a loan originator’s primary objective is to establish a right to the borrower’s house, a predatory practice known as wealth stripping. No responsible lender would operate this way and no loan purchaser would want to take possession of such a problem mortgage. Loan purchasers and reputable lenders will favor provisions in anti-predatory lending legislation requiring documentation of ability to pay for high-cost loans, if they include a clear metric for determining when a borrower is considered able to pay. The following is an example of statutory language taken from a Florida law that fails to provide such a yardstick.

“(6) Extending Credit Without Regard to the Payment Ability of the Borrower. –A lender making a high-cost home loan shall not engage in any pattern or practice of extending high-cost home loans to borrowers based upon the borrowers’ collateral without regard to the borrowers’ ability to repay the loan, including the borrowers’ current and expected income, current obligations, and employment.” (Florida)

Effectively, this law only requires a lender to consider income, other debts and employment when making the determination whether or not to extend credit. It does not indicate at what point a lender could be found in violation of this provision—only that ability to repay must be considered. The statute also fails to succinctly identify what sources the lender should use in making a determination. By contrast, language such as the following passage clearly describes ability to pay and names the documents that should be used to reach this conclusion.

“...The borrower shall be so determined if, at the time the loan is consummated, said borrower’s total monthly debts, including amounts under the loan, do not exceed 55% of said borrower’s monthly gross income as verified by one or more of the following: tax returns, payroll receipts, and other third-party income verification.”

3. Not Objective

- Deceptive practices

Many of the concerns raised by secondary market participants over predatory lending legislation have focused on provisions that are not only vague but also impossible to comply with because loan purchasers cannot detect the prohibited activity through a review of the loan file. Efforts to effectively ban what are considered deceptive practices, for example, are hampered by their inherent subjective nature. It is not possible for loan purchasers to determine whether a lender acted in a fraudulent or deceptive manner based on a review of the loan file. The following examples from Illinois and Michigan of legislative efforts to ban deceptive practices illustrate the challenge in drafting an objective standard.

“Section 25. Good faith dealings; fraudulent or deceptive practices. A lender must act in good faith in all relations with a borrower, including but not limited to, transferring, dealing in, offering, or making a high-risk home loan.

No lender shall employ fraudulent or deceptive acts or practices in the making of a high-risk home loan, including deceptive marketing and sales efforts.”
(Illinois)

“(5) A statement or representation is deceptive or misleading if it has the capacity to deceive or mislead a borrower or potential borrower. The commissioner shall consider any of the following factors in deciding whether a statement or misrepresentation is deceptive or misleading:

- (a) The overall impression that the statement or representation reasonably creates.*
- (b) The particular type of audience to which the statement is directed.*
- (c) Whether it may be reasonably comprehended by the segment of the public to which the statement is directed.”* (Michigan)

Both examples ask the loan purchasers to make determinations that are not possible based on the information provided in the loan file. There is no way—using either routine or extraordinary due diligence—to know whether a lender acted in good faith and avoided deceptive or misleading statements. Loan purchasers cannot comply with the above provisions of the Michigan and Illinois laws. Moreover, it is unlikely any statutory language could be crafted to create an objective test to determine whether a lender had engaged in a deceptive practice.

Conclusion

The Bond Market Association looks forward to working with Congress as lawmakers set out to meet the policy challenge of preserving access to mortgage credit while

providing prudent safeguards against subprime mortgage lending abuses. It is critical, however, that efforts to eliminate the bad element of the subprime mortgage market—predatory lending—do not limit the ability of the secondary market to lower the cost of mortgages while making them more broadly available. The current disparate patchwork of vague and sometimes conflicting state and local laws threatens to do just that. We hope these subcommittees continue to work on a national anti-predatory lending standard that preserves access to subprime mortgage credit and does not assign liability to the secondary market for the actions of lenders that market participants did not observe and cannot detect from the loan file. The Bond Market Association stands ready to assist in this process in any way possible.